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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 752

SOUTHWESTERN HOTEL COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The District Court did not file a written opinion. Its special findings of fact and conclusions of law are printed in the record at pages 22 to 28, inclusive. The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 59–62) is reported at 115 F. (2d) 686.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 19, 1940. (R. 63.) The petition for a writ of certiorari was filed on Febru-

ary 7, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Petitioner, a lessee of certain improved real estate under a 99 year lease, agreed not only to pay a specified rental but also to make payments in discharge of the lessor's mortgage. The question presented is whether the amount paid by petitioner in 1935 upon the mortgage is deductible in full from its taxable income for that year or whether it should be spread over a longer period.

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the tax-

payer has not taken or is not taking title or in which he has no equity.

* * * * *

[U. S. C., Title 26, Sec. 23.]

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 23 (a)-10. *Rentals.*—If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvements made, this deduction shall

take the form of an allowance for depreciation. (See article 22 (a)–13.)

STATEMENT

This suit was brought against the United States in the District Court for the Western District of Texas to recover $989.24 alleged to have been illegally collected from the petitioner as federal income and excess profits taxes for the fiscal year ended August 31, 1935. (R. 1–17.) The District Court made special findings of fact and conclusions of law (R. 22–28), and entered judgment for the United States (R. 37–38). The Circuit Court of Appeals affirmed. (R. 59–63.)

Petitioner is a Texas corporation. (R. 22.) On or about September 1, 1933, one Albert Mathias, joined by his wife, as lessor, entered into a lease contract with petitioner, as lessee, by the terms of which the lessor leased to petitioner certain property in the City of El Paso, Texas, generally known as the Hilton Hotel property. The lease, for a period of 99 years beginning September 1, 1933, and ending August 31, 2032, contained provisions for graduated monthly rentals, and provided that petitioner should pay certain other items (not material here) as additional rentals. The lease also provided that the lessee was to make payment upon a mortgage note which the lessor had theretofore executed (R. 23–24):

ARTICLE III.

ADDITIONAL MONEY RENTALS

(1) As a further consideration for this lease, the Lessee covenants and agrees to pay all sums due and to become due on a certain note, originally in the principal sum of $450,000.00, which is described in a certain Deed of Trust, executed by Albert Mathias and wife and El Paso Hilton Hotel Company on the 28th day of February, 1930 * * *. The Lessee shall have the right to arrange for renewals and extensions of said indebtedness from time to time, and may also arrange for a complete refinancing of same. In such cases, Lessor agrees to execute such Deeds of Trust, mortgages and extension agreements covering both real and personal property as may be required; provided (a) that the terms and provisions of such Deed of Trust, mortgage or extension agreement shall be substantially the same terms and provisions as are now contained in the Deed of Trust and Chattel Mortgage covering said property; and (b) that the amount of the indebtedness then secured by a lien against said property is not increased. In this connection, it is understood that Lessee shall be required to reduce the principal of the indebtedness secured by lien against said property not less than $12,000.00 a year during the first three years, and not less than $20,000.00 a year

> during succeeding years, such indebtedness not to bear interest in excess of the interest rate now provided for * * *.

The unpaid balance on the note held by the Pacific Mutual Life Insurance Company of California on September 1, 1933, was $424,000 and was payable over a period of years, which period was shorter than the estimated life of the building. The estimated life of the building was 33⅓ years. (R. 24.)

There became due and payable on the mortgage indebtedness during the fiscal year ended August 31, 1935, the sum of $18,000, which was paid by petitioner during that year. (R. 24.)

The Commissioner of Internal Revenue ruled that while $18,000 actually became due during the 12 months' period, and was paid, such payment should not be considered as deductible in full for that year, but should be taken together with other payments on the mortgage and spread over the undisputed life of the building, namely 33⅓ years.[1] Pursuant to this ruling, the Commissioner allowed as a deduction for the year 1935 only $12,720, and disallowed as a deduction the remaining $5,280. As a result, petitioner's income and excess profits taxes were increased by $989.24, which, together

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[1] Petitioner originally sought a deduction in the amount of $27,500, but $9,500 thereof was disallowed (R. 24–25), and is not now in dispute. The only controversy here relates to the question whether the remaining $18,000 is deductible in full for the fiscal year 1935.

with interest in the amount of $196.13, was paid on or about March 9, 1939. (R. 25–26.) This suit for refund followed.

ARGUMENT

This case presents neither a conflict of decisions nor a question of general importance. The decision below, based upon the particular facts of this case, is correct.

The applicable statute provides for the deduction from gross income of all ordinary and necessary expenses paid or incurred in the taxable year, including "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business," of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

The courts and the Board of Tax Appeals have consistently construed this provision, as did the court below in this case, as limiting the deduction to amounts paid as rent for the use of the property for the taxable year, and have refused to allow any deduction of amounts paid during the taxable year for the use of the property in future years. The principle was established by this Court in *Duffy* v. *Central R. R.*, 268 U. S. 55. See also *Galatoire Bros.* v. *Lines*, 23 F. (2d) 676 (C. C. A. 5th); *Baton Coal Co.* v. *Commissioner*, 51 F. (2d) 469 (C. C. A. 3d). The issue was recently presented in *Main & McKinney Bldg. Co.* v. *Commissioner*, 113 F. (2d) 81 (C. C. A. 5th),

and this Court denied certiorari, No. 403, present Term. Assumption of a lessor's liability with provision for payment over a period of years is in substance the same as a lump sum payment upon execution of a lease, and is in essence the payment of an amount to acquire the lease. Compare *Alameda Park Co.* v. *Commissioner,* 10 B. T. A. 1115, reversed on another ground, 37 F. (2d) 805 (App. D. C.); *King Amusement Co.* v. *Commissioner,* 44 F. (2d) 709 (C. C. A. 6th), certiorari denied, 282 U. S. 900; *Davison* v. *Commissioner,* 60 F. (2d) 50 (C. C. A. 2d); *Fackler* v. *Commissioner,* 39 B. T. A. 395. Such payments should be amortized over the life of the lease. *Coronado Realty Co.* v. *Commissioner,* 24 B. T. A. 1022; *Minneapolis Security Building Corp.* v. *Commissioner,* 38 B. T. A. 1220.

Whether "Additional Money Rentals" (R. 23), representing payments which the petitioner agreed to make upon the outstanding mortgage note in question, constituted payments for the current use of the property or constituted additional consideration for the granting of the lease depends upon the agreement between the parties. Cf. *Main & McKinney Bldg. Co.* v. *Commissioner, supra.* The court below properly construed their agreement requiring that such payments be made "as a further consideration for the lease" (R. 61) and correctly affirmed the decision of the District Court.

CONCLUSION

There is no conflict of decisions. The decision below is correct. The petition should be denied.

Respectfully submitted.

FRANCIS BIDDLE,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
F. E. YOUNGMAN,
Special Assistants to the Attorney General.

FEBRUARY 1941.

U. S. GOVERNMENT PRINTING OFFICE: 1941